BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Application of Wisconsin Electric Power Company, Wisconsin Gas LLC, and Wisconsin Public Service Corporation for Declaratory Ruling and Approval Regarding Long-Term Natural Gas Storage and Transportation Agreements

Docket No. 5-DR-112

COMMENTS OF THE CITIZENS UTILITY BOARD ON COMMISSION STAFF MEMORANDUM

May 15, 2017

I. INTRODUCTION

Wisconsin Electric Power Company ("WEPCO", Wisconsin Gas LLC ("WG") and Wisconsin Public Service Corporation ("WPSC") (together "Applicants") have petitioned the Public Service Commission of Wisconsin ("PSCW" or "Commission) for a declaratory ruling concerning the reasonableness and prudence of a proposed long-term natural gas storage and transportation transaction. Under the transaction, Applicant's parent WEC Energy Group, Inc. ("WEC") will acquire Bluewater Natural Gas Holding, LLC (BGH), which owns natural gas storage facilities in Michigan ("Bluewater facility"). Applicants currently lease most of the Bluewater facility's total working gas capacity under one to five-year storage agreements with BGH. Under the proposed transaction, each Applicant will enter into a 60-year natural gas storage service agreement with their new affiliate BGH. Sixty years is the forecast remaining depreciable life of the Bluewater facility. The idea is to convert Applicants' current shorter-term leased storage arrangements into something more akin to an ownership interest, providing Applicants with the operational benefits attendant to ownership. Applicants claim the proposed

long-term contractual commitment is preferable to continuation of the status quo arrangement. Applicants claim the proposed arrangement will yield approximately $200 million in net present value savings to customers compared with continuing the status quo storage and transportation contract model. In exchange for their de facto ownership rights, Applicants will be obligated to pay their respective allocated portions of: 1) the full cost of acquiring the Bluewater facility, including the return on and of the price at which WEC acquires the Bluewater facility, and 2) all of the reasonable and prudent expenses of operating and maintaining the facility. Rates that would be paid by Applicants under the storage agreements are based on annual forecast cost estimates, but any difference between the forecast and actual costs would be subject to a true-up surcharge or credit. Applicants have proposed that these costs be recovered through their respective purchase gas adjustment clauses ("PGAC"). Recovery under the PGAC means these costs would not be taken into consideration in Applicants' base rate cases.

In the Scheduling Order issued April 25, 2017, the issues for this docket were listed as follows:

1. Whether it is reasonable, prudent and in the public interest for the Applicants to enter into long-term storage service agreements and related interstate gas transportation contracts in connection with the Bluewater facility;

2. Whether it is reasonable, prudent and in the public interest for Applicants to recover their allocated portions of the full costs of acquiring the Bluewater facility and all of the reasonable and prudent expenses of operating and maintaining the facility through their respective purchase gas adjustment clauses based upon annual demand requirements;

3. Whether it is reasonable, necessary and in the public interest to impose conditions upon the Applicants in connection with their decision to enter into the proposed agreements and contracts.

In the context of these issues Commission staff has described and evaluated Applicants' proposal in a memorandum issued May 1, 2017 ("Staff Memorandum") (PSC REF#: 302108). The

Citizens Utility Board (CUB) hereby submits its comments in response to the Staff Memorandum. Based on the record to date, it is CUB's position that, at a minimum, the Commission should adopt each of the conditions suggested in the Staff Memorandum that are intended to mitigate the risk to ratepayers associated with the 60-year term of the transaction. In addition, the Staff Memorandum makes clear that ratepayers will bear all the cost risk associated with the transaction, permanently and with no apparent recourse, if Applicants are permitted to recover gas storage agreement costs on a one-for-one basis under the PGACs. Given the magnitude of the potential cost risk to ratepayers, which is magnified by the proposed 60-year term, it is not at all clear that this would be reasonable or in the public interest. This conclusion is underscored by staff's questions regarding the actual net present value benefit to ratepayers of the transaction compared with continuing the status quo.

II. COMMENTS

In general, CUB believes the Staff Memorandum raises issues that call into question whether the proposed transaction is in the best interest of Applicants' ratepayers. Specifically, Commission staff's review of Applicants' economic analysis indicates a possibly significantly lower net present value benefit than the $200 million base case calculated by Applicants. If correct, the risks to ratepayers inherent in the very long-term, ownership-like commitment under the terms and conditions proposed by Applicants may not be justified by the net present value benefits.

With respect to whether it is reasonable and in the public interest for Applicants to recover all the costs of acquiring the Bluewater facility, and its on-going capital, O&M, and all other costs under the PGAC, the Staff Memorandum notes this places on ratepayers all the risks associated with the storage agreements over their 60-year terms. It is not clear to CUB at this

point in the proceeding how that result can be justified. In addition, to the extent that cost recovery through the PGACs is tantamount to "no questions asked" recovery, it may be inconsistent with the Commission's continuing obligation and authority under Wis. Stat. §§ 196.52, et seq., to review the reasonableness of payments by public utilities pursuant to affiliate agreements.

A. Economic Analysis (Net Present Value) Issue

The Staff Memorandum identified three areas of concern with respect to Applicants' economic, or net present value analysis. First, staff questions the discount rate used by Applicants. Second, staff identified concerns with the 60-year term of the gas storage agreements. Third, staff questioned the capital and O&M expenditure growth rate used by Applicants.

1. Discount Rate

Applicants calculated a discount rate of 7.19 percent, based on a blended weighted cost of capital from the most recent rate cases for each of them. Using a higher discount rate, all other things being equal, will result in a lower net present value benefit amount. Staff's concern centers around its view that the discount rate proposed by Applicants is not reflective of the "specific risks and financial characteristics" associated with the proposed transaction. (Staff Memorandum at 16-p) As an alternative staff proposes the use of a marginal weighted cost of capital to be used in "funding the proposed transaction in particular" at the time the transaction will be executed, taking into account any tax deductibility on the debt piece of the financing. (Id. at 17-p). Using the marginal WACC yields significantly higher returns on equity and cost of debt compared to Applicants' assumptions. Staff's analysis results in a discount rate of between 7.92 percent and 11.34 percent, with the median being 9.53. Using even staff's lowest

alternative discount rate shaves $88 million off Applicants' forecast base case net present value benefit, while using staff's median rate reduces the net present value benefit to $11 million. These significantly lower net present values, which are exclusive of the impacts associated with staff's contract term and growth rate risk adjustments, indicate there may not be a sufficiently large monetary benefit to ratepayers associated with the transaction as proposed to justify the significant longer-term risks to ratepayers identified in the Staff Memorandum.

2. Gas Storage Agreement Term

Staff says it is "concerned with the 60-year time horizon of the proposed transaction" and explains how Applicants have not adequately factored the financial risks to ratepayers associated with that long-term commitment into its the economic analysis. (Staff Memorandum at 18-p to 21-p). Staff's concern centers on Applicants' failure to adequately account for the financial risk inherent in a very long-term natural gas storage deal. This term or duration driven financial risk is caused by the increasing likelihood over a long time horizon that one or more low-probability but high cost events will actually occur. As staff notes, these events cannot feasibly be hedged. (Id., at 19-p) Staff specifically identifies two such risks. First is the simple observation that changes in the natural gas market in future years could limit the Applicants' natural gas storage needs "to the point where the proposed 60-year gas storage contracts may be unnecessary." (Id., at 20-p) If such an eventuality were to occur, it seems at a minimum the Commission could have a difficult stranded cost problem on its hands. Second, staff concludes Applicants "did not quantify the nature and impact of potentially catastrophic events" such as a well blow-out event (Id.) Presumably such an event would render the Bluewater facility inoperable either for some extended period of time or permanently, but Applicants – and therefore ratepayers – would still

be on the hook for any remaining depreciation of their respective shares of the capital investment, absent some contractual or equitable remedy.

Staff did not calculate a financial hit to Applicants' net present value base case associated with these events. Presumably, in most cases the occurrence of these types of events would wipe out any benefit or, in fact, result in a net cost to ratepayers compared to the alternative arrangement. According to staff, Applicants have not adequately taken these risk scenarios into consideration in their net present value analysis. It may be that neither Applicants, nor anyone else for that matter, can reasonably model these events and capture their impact on the transaction's net present value compared to continuation of the status quo. It may make more sense instead for the Commission to adopt each of the conditions described by staff to help mitigate these and other unidentified risks to ratepayers associated with the 60-year term of the storage agreement. These conditions are discussed below in section 4.

3. Capital and O&M Expenditure Growth Rate

Not surprisingly, annual expenditure growth rate assumptions on these costs have a significant impact on the level of net present value benefit or cost. Applicants used a straight-line three percent growth rate over the entire 60 years. Staff questions whether the three percent number is too low, and whether use of the straight-line escalation used by Applicants is appropriate. Staff's lowest alternative escalation number is five percent. Using a five percent escalator trims $67 million off Applicants' base case net present value benefit. Added to the reduction attributable to using staff's most conservative (lowest) discount rate alternative, this would significantly reduce the overall net present value benefit.

Using a straight line to escalate these costs over the 60-year period is questionable inasmuch as it fails to account at all for the magnified event uncertainty inherent in a 60-year

deal, as described in the Staff Memorandum, and "masks the impact of volatility in the future that can affect cost recovery and customer bills." (Id., at 21-p). The Commission should discount Applicants' net present value analysis accordingly.

4. <u>Conditions to Mitigate Term Related Risks</u>

Staff identified three conditions (conditions 6, 7, and 8) that could be adopted by the Commission to mitigate risks to ratepayers associated with the transactions 60-year term. (Id., at 20-p to 21-p) CUB believes these conditions would be appropriate measures to mitigate the uncertainty around the escalation factor issue as well, which is essentially a duration driven risk.

First, staff suggests the Commission could impose a condition under which it "reconsiders the reasonableness of the proposed gas storage contracts every 10 or 15 years" based on a number of factors. (Id., at 20-p) CUB supports this condition, but suggests such review occur no less frequently than every five years. Applicants have stated they believe "by the fourth gas year under the service agreements ratepayers should experience annual net rate decreases that get larger over time" (Application at 26) (PSC REF#: 297634) Therefore, a five-year review cycle would allow the Commission to evaluate the transaction in light of Applicants' forecast. In addition, the order point on this condition could clarify that it does not preclude more frequent review on the Commission's own motion or upon application or complaint under Wis. Stat. § 196.52 (4).

Staff's second condition would require language in the storage agreements "allowing for cancellation or renegotiation if events materially affecting the economic savings" occur. (Staff Memorandum at 21-p) This condition appears to be consistent with the Commission's authority under Wis. Stat. § 196.52 (5), which, among other things, provides that orders approving affiliate contracts "shall be expressly conditioned upon the reserved power of the commission to revise

and amend the terms and conditions of the contract or arrangement to protect and promote the public interest." (Id.) CUB supports this condition, but suggests an order point on this condition should clarify that such contractual language is not intended to bound the Commission's authorities under Wis. Stat. 196.52 (5).

Staff's third condition would require Applicants to "periodically submit information that would allow Commission staff to verify that the proposed transaction is in fact creating customer savings." (Staff Memorandum at 21-p) This proposed condition likewise seems consistent with the Commission's continuing supervisory control over the terms and conditions of contracts and arrangements under this section as necessary to protect and promote the public interest, under Wis. Stat. §§ 196.52 (4), (5). CUB proposes that the information be reported annually and at the same time by each Applicant so that Commission review can be coordinated. Such reporting requirements and ongoing assessments would help inform the Commission of the value of these transactions inasmuch as Applicants, and other public utilities and their respective holding companies, may contemplate additional gas storage investments.

B. Cost Recovery Mechanism Issue

Applicants propose to recover their costs and pass through the revenues they receive under their storage agreements through their respective PGACs. The Staff Memorandum bluntly states the consequence of this proposal:

> *If the applicants are permitted to recover the gas storage contracts on a one-for-one basis through their PGACs, the applicants' ratepayers bear all the risk associated with the 60-year contracts. The applicants would be guaranteed recovery of all charges incurred under the gas storage contracts regardless of how the market may change, and the ratepayers would be required to pay for such contracts even if they prove uneconomic in the future.*

(Staff Memorandum at 26-p, italics added) To the extent that cost recovery is independent of Applicants' base rate cases and essentially guaranteed, it appears Applicants would lack any incentive to work with their affiliate BGH to keep costs low, or to seek additional revenues from opportunity sales. As a consequence, staff concludes that recovery through base rates "may more appropriately balance risk and reward among shareholders and ratepayers." (Id.) Under this model, staff concludes the storage agreements would be classified as operating leases, and Applicants would be required to request inclusion of lease costs, including depreciation on plant, return on equity, interest expense, O&M, and income taxes, in a rate case revenue requirement. As such, the Commission will be able to establish Applicant's natural gas rates based, in part, on the costs of the storage agreements, not separate from those costs. It will allow the Commission to set natural gas rates based on Applicants' load and total costs, rather than total rate case costs minus BGH storage agreement costs. It would seem this would give the Commission the flexibility, for example, to push some total gas revenue requirement cost back onto shareholders to the extent total costs are not supported by total load. In exchange for this cost risk sharing, shareholders would retain any opportunity sales and benefits from increased sales. (Staff Memorandum at 27-p) If the Commission agrees storage agreement costs must be recovered in rate cases, then CUB suggests the Commission order storage agreement costs be deferred, with carrying costs at the short-term debt rate, until each Applicant's next full rate case.[1]

Alternatively, staff proposed that if the Commission adopted Applicants' proposal to use the PGAC, it could condition approval on a used and useful review of the storage agreements every three years. (Id.) While CUB would support making this a condition of any Commission approval of the PGAC mechanism for cost recovery, it is not clear that a used and useful review

[1] Staff's proposed condition 11 provides two options for the Commission in the event it determines gas storage costs must be recovered through Applicants rate case: 1) defer the costs, or 2) recover them through their PGACs, until each of the Applicants next full rate case. (Staff Memorandum at 34-p)

provides the same certainty and robustness of ratepayer protection as staff identifies if storage costs are recovered through the rate case process.

C. Other Conditions

In addition to the conditions discussed above, the Staff Memorandum proposes five additional conditions. (Staff Memorandum at 33-p, conditions 1-5) Most of these conditions appear to be intended to clarify, establish, or preserve the Commission's jurisdiction over the proposed transaction, including pursuant to the declaratory rulings provisions of the Wisconsin statutes. (Id., conditions 2, 3, 4, 5) CUB supports each of these conditions for the reasons described in the Staff Memorandum.

CUB also supports proposed condition 1, which provides that "any declaratory rulings that [the Commission] may issue are strictly based on the set of facts established in this proceeding, and are only valid to the extent that set of facts remains in place, and are void to the extent that set of facts changes." CUB interprets this condition as a "no precedent" statement with respect to the Commission's final decision in this docket, such that any future similar proposal may not be approved merely on the basis of any approval in this case. In addition, the language conditions any Commission approval of the proposed transaction only insofar as the set of facts "established in this proceeding" and upon which such approval is based remain in place, and that such approval will be void to the extent those facts change. In other words, the Commission's approval is conditioned on the facts averred by Applicants coming to pass. Since, as made clear in the Staff Memorandum, Applicants' ratepayers essentially bear all the cost risk of this transaction, while Applicants themselves largely control the terms and conditions of the transaction, this condition seems reasonable and appropriate.

III. CONCLUSION

The Staff Memorandum strongly suggests that Applicants' net present value analysis is insufficiently risk adjusted, so that the benefits to ratepayers of the proposed transaction, compared with continuation of the status quo, may be overstated. Stated another way, the risks to ratepayers associated with the transaction may not be sufficiently offset by the benefits. As such, it is important that these risks be mitigated to the greatest extent possible. Staff has proposed a number of conditions (staff conditions 6, 7, and 8) that attempt to mitigate ratepayer risks, and that appear to be consistent with the Commission's existing statutory responsibilities and obligations regarding oversight and review of affiliate agreements in Wis. Stat. § 196.52. For the reasons described herein, with respect to the first issue, CUB supports Alternative Two, but subject to staff's conditions 6, 7, and 8.

The Staff Memorandum unequivocally concludes that recovery of storage agreement costs through the PGACs places all cost risk on ratepayers for 60 years, basically without any recourse. Commission staff appears to conclude recovery of storage agreement costs through Applicants' rate cases better allocates the risks of the transaction between shareholders and ratepayers. Consequently, with respect to the second issue CUB supports Alternative Three, and recommends the Commission reject this part of Applicants' proposal and to order that storage agreement costs be recovered through Applicants' rate cases. If the Commission approves cost recovery through the PGACs, then in order to provide some protection to ratepayers it should condition that approval on reviewing the storage agreements every three years under the used and useful standard, consistent with staff condition 9. Finally, CUB supports staff conditions 1-5 for the reasons stated herein.

CUB reserves the right to change or amend its positon in the second round of comments in light of other parties' comments or additional information that becomes available over the balance of this proceeding.

Dated this 15th day of May, 2017.

Respectfully submitted,

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